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Malaysian Capital Controls

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Late in the Asian crisis, Malaysian authorities implemented controls on international capital flows, providing insurance against the consequences of possible further disturbances and creating a breathing space for essential reforms. Both the benefits from and the costs of the controls have been modest.

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Summary findings

Malaysian authorities implemented controls on international capital flows late in the Asian crisis, when most of the portfolio outflows had already occurred. The exchange rate had depreciated sharply and was fixed at an undervalued level, making further capital flight unlikely.

The turnaround in the stock market, the return of positive GDP growth, the building of reserves, and the relaxation of interest rates all coincided with the imposition of controls. But the same changes took place in other crisis countries that did not follow the same control policies.

However, the controls provided insurance against the consequences of possible further disturbances. They created a breathing space for making needed reforms, and the authorities made good use of this time, stabilizing the financial system and pushing ahead with regulatory and supervisory reform for the financial sector and capital markets—a prerequisite for fully liberalizing the capital account.

Malaysia incurred a cost: an additional 300 basis point spread paid on floating rate debt for a period after the controls were instituted. But the exit strategy has so far not resulted in lasting flight of portfolio capital. Foreign direct investment remains below precrisis levels, but it is not possible at this stage to attribute this to the effect of controls.

On balance, it appears that both the benefits from and the costs of the controls have been modest.

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EASPR

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Introduction

The trend in the recent past has been towards liberalization of capital markets motivated by a desire for economic efficiency: the free cross border flow of capital seeking the highest rate of return results in its most efficient use. Controls on capital flows mean that both borrower and lender forego potential gains. The use of controls is sometimes justified using second best arguments related to market imperfections such as asymmetric information. More frequently, however, controls are used for reasons that relate to the classic policy dilemma stating that one cannot simultaneously have free capital movement, a fixed exchange rate and an independent monetary policy. By controlling capital movement authorities are free to set interest rates in line with domestic needs while enjoying the stability afforded by a fixed exchange rate. Speculative pressures that would otherwise necessitate sharp defensive moves in domestic interest rates (or precipitate large exchange rate movements under a flexible rate regime) can be contained by elimination or containment of the capital flows themselves.

Controls can be on inflows or outflows. *Inflow controls* are most commonly used in the context of a speculative bubble. They free the authorities from the need for large scale sterilization to counter inflationary pressures created by the inflows, and they mitigate the distortionary effect that the exchange rate appreciation will have on external trade and production. In addition, large inflows of short term capital distort the maturity structure of debt and strain the capacity of the domestic financial system to intermediate efficiently. This problem is most acute when regulatory and supervisory systems are weak. Controls were used in this context in Malaysia (1994), Chile (1991-98) and Thailand (1995-97). *Controls on outflows* are more commonly associated with a speculative collapse and currency crisis as was the case in Malaysia (1998-99), Spain (1992) and Thailand (1997-99). In these countries the capital account had previously been largely liberalized. The controls were adopted when there was strong speculative pressure against the currency, declining reserves and domestic interest rates had already been raised to levels that were further weakening already depressed domestic demand.

Market-base controls rely on special taxes, non-interest bearing deposit requirements or dual exchange rate systems. These types of controls serve to raise the cost of specific capital account transactions and thereby discourage flows. They have been used to control both inflows and outflows, and they are most commonly applied to counter foreign speculation. *Administrative controls* involve limits or bans particular capital account transactions and are usually administered through the banking system. One of the most common is a ban on currency swap transactions. Capital controls are closely linked with exchange control measures as is the case with the swap controls and the two-tier exchange systems. Authorities have sometimes sought to limit offshore trading of domestic currency (Malaysia and Thailand) and equity (Malaysia) as a means of containing speculative pressure during the control period.

Malaysian Experience Before the Crisis

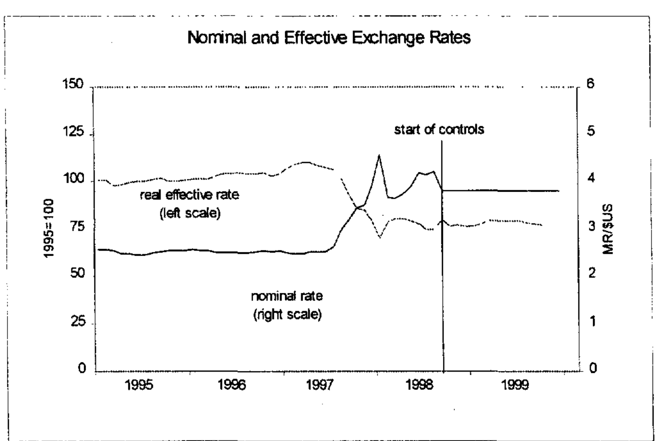
Since floating the ringgit in 1973 Malaysia began a steady process of liberalizing capital account transactions. A major relaxation in 1987-89 was accompanied by steps to deregulate the financial system. However, in the early 1990s Malaysia experienced a surge of short- and long-term capital inflows. While the long-term flows were related to strong economic fundamentals, the short-term flows were drawn by high domestic interest rates which the authorities felt necessary to contain inflation. The inflows, which resulted in a sharp build up of debt securities and external liabilities in the banking system, were regarded as dangerously reversible. Sterilization operations were both expensive and ineffective since they kept interest rates up. After a series of increases in reserve requirements and fearing loss of control of the monetary base, BNM imposed several direct and market-based controls on capital inflows in February 1994. These included limits on sale of short term securities to non-residents, speculative swaps and forward transactions, and banks' non-trade-related external liabilities, and a requirement for non-interest-bearing deposits against foreign bank ringgit accounts with domestic banks. The reaction was swift. The stock market underwent a correction, and a sharp reversal in short term flows in the second half of 1994 caused the capital account surplus to shrink. The controls were dismantled by the end of the year. The control measures were thus effective, although the ending of sterilization operations and the reduction in the interest differential also helped inhibit the inflows.

With the passing of this episode Malaysia resumed its policy of progressive liberalization. As of 1997 the authorities allowed trade payments to be made in ringgit, financial transactions with non-residents were subject to few limitations, portfolio inflows were unrestricted and portfolio outflows were subject to ceilings only for corporate residents that had borrowed domestically. Supplier credit to non-residents could be extended for up to 6 months without limitation. Approval was required for primary issuance of securities by non-residents and issuance of securities abroad by residents, but banks could borrow abroad and could lend foreign exchange to residents and non-residents, although foreign currency borrowing by residents required approval above certain amounts. Foreign direct investment, both inward and outward, was completely free except for some sectoral limitations. (see Table 1 for details)

With this freedom there evolved an active offshore market for the ringgit located primarily in Singapore but with trading also taking place in London, New York and Hong Kong. This market was attractive because spreads tended to be narrower than in the domestic market in part because participants were not subject to the same high reserve ratio that BNM required of onshore institutions. The market consisted of all transactions outside Malaysia involving ringgit on one side or other including currency trading, deposit taking, lending and trade in derivatives such as swap contracts and options. External trade transactions could be denominated and settled in ringgit. This removed the need for Malaysian exporters and importers to hedge the foreign exchange risk. However, the foreign trade partners had to hedge their ringgit risk and they did so with such instruments as swap contracts and options offered through the offshore market. Besides offering efficient trade and hedging opportunities the offshore market provided a means of establishing a benchmark yield curve for Malaysia. This is important for allowing both foreign and domestic investors to efficiently price risk of Malaysian securities and contributes the development of the private debt securities market which continues to be a key objective in Malaysia' capital market development program.[1]

The bulk of offshore trade was made possible by the system of external accounts consisting of ringgit deposits of foreign banks held with resident Malaysian banks. The deposits in the external accounts represent the ringgit under the control of foreigners and are foreign liabilities of the banking system. Offshore transactions, whether for trade or speculative purposes ultimately have to be settled by transfers between these external accounts. Those wanting to speculate against the ringgit could do so through the offshore market. Basically speculators want to have ringgit liabilities. For instance they might borrow ringgit now from their offshore bank with repayment due in ringgit at a future date. The speculator's bank could accommodate this demand, by hedging its ringgit exposure. It might do so by entering a swap agreement to lay off the currency risk. Alternatively, it could draw funds from its external account to advance to the client. This creates offsetting changes in ringgit assets and liabilities. Equivalently it might borrow ringgit from its correspondent bank in Malaysia or increase rates to attract ringgit deposits thereby creating a ringgit liability to offset the ringgit asset it holds in the form of a loan to its client.[2] Whatever the hedging mechanism the net effect of the speculation is to increase the demand for ringgit credit, increase short term interest rates and put forward pressure on the currency.

The Crisis



Malaysia had several economic strengths going into the crisis. In June 1997, the ringgit was trading at 2.52 to the U.S. dollar, and had been close to that value since January 1995. Inflation was running at an annual rate of 2.2%. The real effective exchange rate had appreciated somewhat over the longer term but was only about 8 percent above its 1995 level and was declining. Foreign exchange reserves were USD 27 billion or about 26% percent of GDP and had been steady in this range for over a year. External debt at the end of 1996 was 31% of GDP down slightly from levels of the previous three years. Short term debt was only a quarter of total debt.

[1] A riskless benchmark yield allows market participants to observe risk premia for private issues. The return on (close to riskless) Malaysian Government Securities (MGS) does not provide such a benchmark because the MGS yield is depressed by the captive demand created for MGS generated by reserve requirements and MGS holdings required of the state pension fund. Swap prices can be used to translate (riskless) US treasury yields into ringgit yields which provide the necessary benchmark.

[2] Typically banks that are active internationally open reciprocal accounts for the clearance of letters of credit and the like. There is often an understanding that certain balances will be maintained in such "vostro" accounts in order to facilitate transactions and there may be further arrangements for automatic extension of local currency credit often backed by securities denominated in local currency.

However, there were some indications of weakness. The current account was in deficit. Domestic credit growth had reached 36% annually and was accelerating. Credit expansion to the property sector was increasing at 30% a year contributing to asset inflation. Shares on the KLSE rose by 24.4% in 1996 and reached a three-year high in February 1997. Stocks on the second board rose 93% in 1996 reaching a peak in March 1997 with a PE ratio of 58.

Initially, selective credit controls were introduced to counter asset price inflation...... During the first half of 1997 BNM was concerned that the wealth effects of the asset price rise, combined with strong credit expansion would contribute to inflation and increased vulnerability of the banking system to any drop in demand. Accordingly, the authorities imposed ceilings of 15% and 20% respectively for bank credit secured by property and stock. BNM disseminated information on the over-supply of office and retail space in order to cool demand. BNM basically hoped to contain pressures via the credit ceilings. The sense was that the productive sectors were not over extended like the property and stock markets, and that high interest rates would be damaging.

...... and then interest rates were hiked to defend the ringgit...... With the devaluation of the Thai bhat in July, strong pressures began to build against the ringgit. Portfolio positions in the stock market were liquidated causing the KLSE to plunge. BNM intervened in the foreign exchange market buying up ringgit and reducing liquidity and causing rates on overnight money in the interbank market to spike up to 40%. Thus the authorities initially attempted to defend the ringgit through interest rate hikes. But the persistence of the exchange rate pressures and the floating of the Philippine peso indicated that the instability would be longer term and that a protracted period of high interest rates might be necessary.

...... which lead to a rise in NPLs..... NPLs began to increase in the latter part of 1997 and accelerated in 1998 as the economy contracted. The situation was worst among the finance companies which held just under a quarter of all loans and had expanded most aggressively in real estate and share purchase lending. The NPLs continued to mount and began affecting the commercial and merchant banks as well. As financial institutions became more preoccupied with NPLs, loan loss provisions and capital adequacy, the volume of lending began to slow. Credit worthiness of some borrowers was impaired by the higher interest rates and the contraction in demand, leading to fears of a credit crunch. Among other borrowers the demand for credit simply declined in line with sales. By early 1998 the authorities main concern was that credit expansion would be insufficient to sustain recovery.

....and eventually capital controls. Net flows of portfolio capital had been positive on an annual basis since 1992. On the tide of speculative pressure, net outflows of RM10 billion emerged in the first three quarters of 1997. On August 4, 1997 BNM imposed a $2 million limit on domestic bank's offer side swaps with non-residents in an effort to stem the speculative flows. This had only a modest effect in slowing the exodus of capital. As outlined above, there are several channels for speculative activity and the swap limits served only to put a wedge between domestic and offshore ringgit interest rates. By August 1998 interest rates on offshore ringgit deposits rose to more than 20% compared with 11.4% rates on deposits in Malaysian Banks. The ringgit which had slid by 4.2% in July 1998 dropped a further 12.4% in August. Fearing an acceleration of capital flight and pressure on domestic interest rates, on September 1, 1998 BMN imposed a package of capital account regulations.

The Imposition of Capital Controls

The capital controls were complex and comprehensive. Basically they sought to eliminate the opportunity for taking speculative positions against the ringgit by eliminating all international financial transactions not related to underlying trade and FDI. They effectively closed the offshore market, cut off ringgit credit to foreigners and put a moratorium on portfolio outflows. The details of this regulations appear in Tables 1 and 2 but the main elements were as follows.

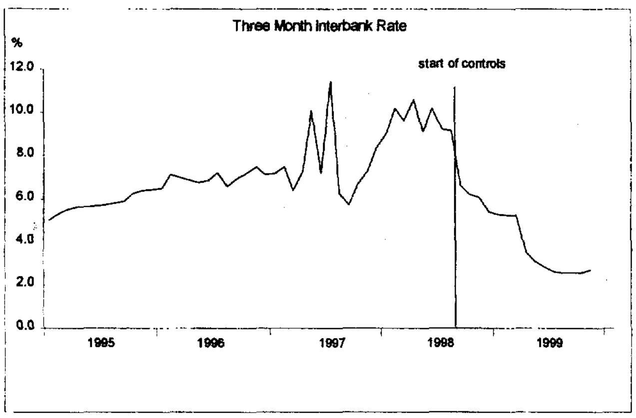
1. A one year waiting period imposed on repatriation of the proceeds of sales of Malaysian securities held in external accounts.
2. Mandatory repatriation of all ringgit held abroad.
3. Restriction on transfers of funds between external accounts.
4. Limits on transport of ringgit by travellers.
5. Prohibition of resident/non-resident credit arrangements.
6. Prohibition of trade settlement in ringgit.
7. Prohibition of resident/non-resident offer side swaps and similar hedge transactions.
8. Freezing of CLOB share transactions.

On February 15, 1999 the one year waiting period on portfolio capital outflows was replaced with a set of graduated exit taxes. The basic arrangement was to distinguish repatriation of principal from repatriation of profits, and investment made before February 14, 1999 from that made after. For investments made prior to February 14 1999, principal was to be taxed at a declining rate and would cease to attract any levy after one year from its time of entry or from September 1 1998 which ever was later. For investments made after February 14, 1999 there was no tax on principal. For investments made before February 14, 1999, profits would be taxed at zero if repatriated before September 1, 1999 and at 10 percent thereafter. For investments band after February 14, 1999 profits would be taxed at 30% falling to 10% if held for one year or more. On September 21, 1999 a further adjustment was made to exempt investments made between September 1 1998 and February 14, 1999 from the 10% exit levy on principal.

The immediate objective of the control policies was to stem the speculative pressure on the ringgit, and to provide stability through moderation of domestic interest rates and a pegged exchange rate. These policies were regarded as temporary measures. In part they were seen as insulating the economy from an external shock and the contagion effects of the financial crisis in neighboring countries. It was recognized that there were some structural weaknesses in the Malaysian financial and corporate sectors that would have to be addressed in medium term. The capital controls seen as providing a breathing space during which the authorities could launch programs to deal with these problems and help restore confidence and reduce balance of payments pressures.

BNM administered the controls through the banks. Its historically tight control over the banking system with frequent reporting intervals and on site supervision made it possible for them to ensure strict compliance. Clear documentary evidence was required for all international financial transactions clearly linking the transaction to underlying trade or foreign direct investment. The complexity of the controls caused some confusion at the outset. However, BNM conducted an effective information campaign placing detailed descriptions of the control measures before the public including postings on its web site. Over time it provided updates, clarifications and worked examples detailing how the controls were to be applied to a variety of transactions.

Events Following the Imposition of Controls



The capital controls had several immediate effects. First, the prohibition on transactions between external accounts put an immediate and virtually complete stop to offshore ringgit trading. Second, the 12-month holding period was instrumental in curtailing speculative capital outflows. BNM was also careful to identify and close off virtually all other channels for speculative capital outflows including the freezing of trade in CLOB shares[3], amendment of the Companies Act to prevent dividend distributions, and withdrawal of large denomination notes from circulation.

The interest rate changes were closely coordinated with the introduction of the controls. The 3-month interbank rate which is BNM's policy rate had been hiked in stages from 7.6% in September 1997 to 11.0% in February 1998 as part of the initial monetary tightening strategy. It stayed in this range until August 1998. As the controls were introduced and it became clear that the offshore market had been effectively shut down, BNM gained confidence that they had successfully reversed the globalization of the ringgit and began to relaxed interest rates. The 3-month interbank rate fell to 7.75 in September. Further cuts were made in April 1999, and by end 1999 the rate was 3.15%. Inflation (CPI) which was 5.6% in August remained on a steady downward trend to 2.5% by end 1999. The banks' base lending rate is linked to the interbank rate and the banks were required to reduce the maximum margin over the base lending rate from 4 to 2.5 percentage points with effect from September 14. As a result bank and finance company lending rates at the fell by 4-5% over the last half of 1998, although the cap on lending spreads limits the ability of financial institutions to efficiently price risk. Banks were also

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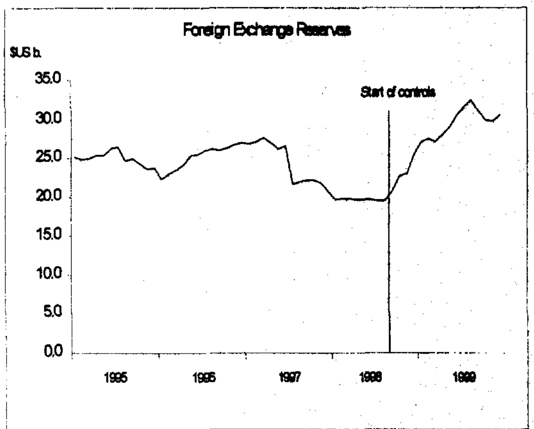
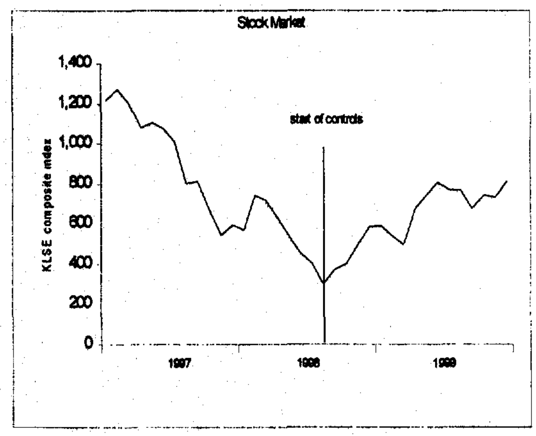
[3] Singapore investors were unable to dispose of an estimated 4.9 billion dollars worth of CLOB shares and this remained a source of irritation until it was resolved in February 2000 when the Singapore and Kuala Lumpur exchanges came to agreement on the registration and phased release of the shares through the Malaysian Central Depository.

encouraged to achieve a the minimum target of 8% loan growth. The statutory reserve requirement was reduced in several rounds from 13.5% in February 1998 to 4% by September 14.

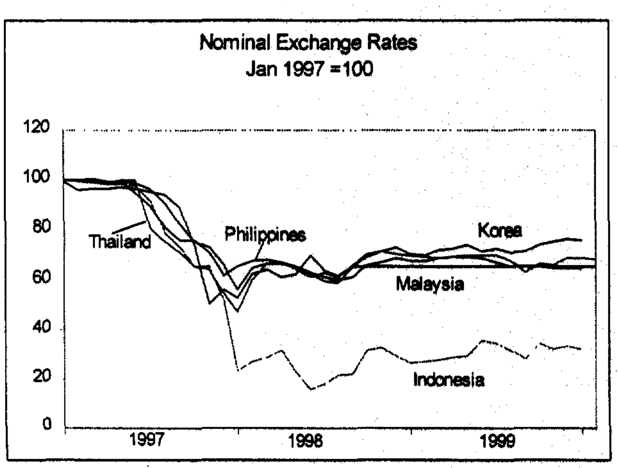
The September 1 announcement of capital controls coincided with the stock market low of 262. From there the market rose steadily for six months to over 600.





The current account continued to strengthen and with the controls on outflows, international reserves which had been equal to 3.3 months of imports in the first quarter of 1998 jumped sharply to 4.3 and then 5.7 months of imports in the third and fourth quarters respectively.

Regional Reactions to the Crisis



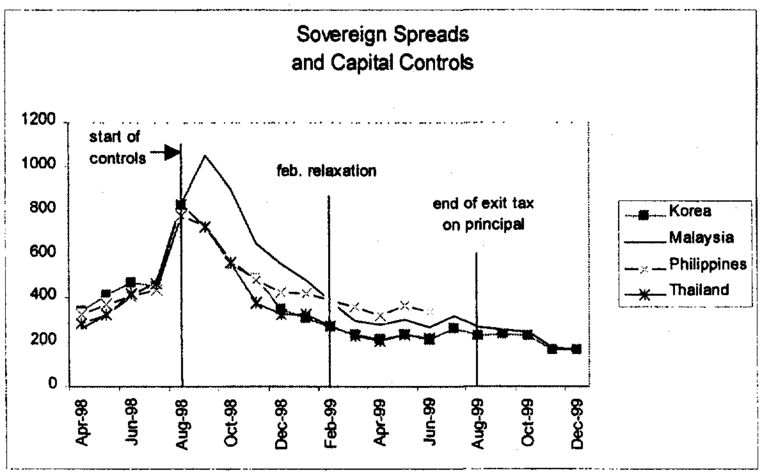
It is important to place these events in the context of the developments in the region as a whole. Despite its sharply different policy on capital controls, the pattern of the recovery in Malaysia is very similar to that of other countries of the region. In Malaysia, Korea, Thailand, Indonesia, and to a lesser extent the Philippines, substantial import contractions starting in the last quarter of 1997 lead to a buildup of reserves and greater confidence in regional currencies. Nominal exchange rates of these countries all bottomed out near the beginning of 1998 and stabilized by Q3, allowing monetary loosening and relaxation of interest rates. The recovery of GDP growth began in Q2. 1998 in Korea and Thailand, in Q3 in the Philippines and Malaysia and in Q4 in Indonesia, following fiscal stimulus applied in all of the countries in 1998, and expanded in 1999. The similarity of these developments and the close timing of the changes in the different countries makes it very difficult to attribute a significant and distinct role to the Malaysian exchange controls in bringing about recovery, despite the fact that their imposition coincides roughly with the turnaround in Malaysia's economic performance in Q3 1998.

Thailand also imposed capital controls, but it did so in May 1997, 17 months before Malaysia and removed them again after only eight months. They were introduced at the height of the speculative attack on the baht when there was heavy demand for baht credit. Borrowed baht were converted into foreign exchange in anticipation of a devaluation, putting downward pressure on the exchange rate and draining reserves. The controls were effective in shutting down the swap market domestic banking system sources of baht credit, and creating large losses for speculators. The capital controls were not as tightly enforced as in Malaysia, however, and alternative channels for baht outflows were exploited to arbitrage the gap between onshore and offshore borrowing rates which widened to 12.9% in early June 1997. These outflows continued to drain reserves and the central bank eventually let the baht float on July 2 1997. The baht fell more than 50 percent by time the controls were lifted in January of 1998. It then appreciated by roughly 30 percent and stabilized at that level within four months. The realignment of the baht was critical in defusing the external pressure. The launching of financial and corporate restructuring efforts and other structural reforms were necessary to re-establish sufficient confidence to allow interest rates to decline. If anything it was the *removal* of controls in January that contributed to building this confidence. Basically, Thailand used controls to defend a fixed and overvalued exchange rate but could not, and eventually had to give up.

In Malaysia the ringgit was under a managed float. Like Thailand its exchange rate depreciated by 80 percent in the seven months ending January 1998. As the government launched comprehensive restructuring programs in the corporate and financial sectors the currency began to strengthen. There were advances and retreats but by September 1998 the exchange rate had appreciated by 20 percent from its January low. Only then were the Malaysian capital controls imposed and the exchange rate pegged. In Korea there was a progressive loosening capital account restrictions from 1987 on but the regime was less liberal than either Thailand or Malaysia. Offshore trading was limited and with flexible exchange rates and high interest rate policy, speculative activity against the won was minimal during the crisis. Korea made no adjustments to the capital control system focussing instead on corporate and financial sector reforms. These events point to the importance of establishing credible structural reform programs as well as flexibility in exchange adjustment as key to recovery and the return to stable growth. The fact that capital control policies were not adjusted in the other countries of the region, save in Thailand where they were lifted some eight months prior to the recovery, suggests that at most they may have been of use as a short term stabilization device.

Costs and Benefits of Controls

In retrospect one can see that Malaysia's controls and exchange peg came when the worst of the crisis had passed, but it as of mid-1998 it was not at all clear that regional economic disturbances had settled. The Malaysian policies therefore did provide a safeguard against further turbulence in international capital flows and financial markets and the authorities made effective use the breathing space afforded by the controls to launch the structural reforms necessary for longer term growth. These included the establishment of Danamodal to recapitalize banks, and Danaharta to carve out NPLs and begin corporate and financial restructuring. Bankruptcy laws and courts were modernized, a major corporate governance drive was launched and a comprehensive program of banking sector supervision and regulation was begun. In these areas Malaysia has made greater progress than many of its neighbors. The absence of a counterfactual makes it difficult to determine whether these reforms might have made as quickly or deeply in the absence of capital controls but the controls arguably provided a margin of safety by insulating the economy from potential further shocks so that these critical programs could be launched with confidence.

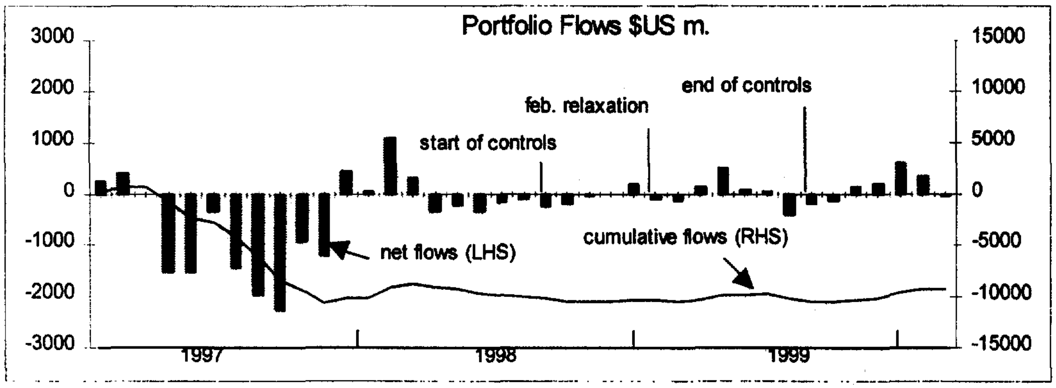


There are several potential costs to the imposition of controls. They create uncertainty for foreign investors and may raise the cost of capital. Ratings agencies including Fitch and Moody's downgraded Malaysia's sovereign risk and credit ratings shortly after introduction of the controls. Spreads on Malaysian sovereign debt instruments increased to 1000 basis points from less than 50 basis points prior to the crisis. Spreads for almost all developing countries increased sharply after the Russian default in August of 1998. But the Malaysian spread jumped about 300 basis points more than the spreads for Thailand, Korea and the Philippines. The subsequent decline in the Malaysian spread also lagged that of the other countries by about two months.

Foreign direct investment flows dropped substantially in 1998 and 1999 and have remained weak in 2000 as well. However, the excessive rates of pre-crisis investment and the emergence and continuing presence of excess capacity throughout the region mean that it is too early to tell whether the controls have had (or will have) an independent depressing effect on FDI.

A second problem with controls concerns the exit strategy. From the beginning it was announced that the Malaysian controls were to be temporary, in part to minimize the impact on investor sentiment and the country risk premium. The relaxation of capital controls in February was partly a signaling device to reinforce in the public mind that the controls were temporary. Fears that capital would flee as the exit ban was replaced with exit taxes proved unfounded as very small outflows were recorded in February and March, and there were net inflows in April through July despite further announced reductions in exit taxes in April and again in June. The elimination of exit taxes on repayments of principle in September resulted in modest outflow of only about US$300 million. Outflows were anticipated in the stock market, and the KLSE index which had been on a strong upward trend from early April, fell by more than 20 percent between mid-July and early September. By early October the situation had stabilized, and net inflows were recorded in each month from November 1999 through February 2000.

It is important to keep the magnitude of these numbers in perspective. Net flows in the control period and its aftermath were very small compared with RM 10 billion that left in 1997 at the height of the crisis. The decline in the stock market was short lived and not that large in the context of the massive swings of the recent past.



The passing of September 1, 1999 did not signal the complete end of controls. There remains the 10% exit tax on profits making Malaysia less attractive to investors relative to most other middle income countries[4]. Removal of this tax should have a positive effect on foreign investment as well as simplifying the system.[5] However, the rate is low and although it involves some compliance costs its applicability has been narrowed to exclude real estate, second board stocks and certain other items.

Resident investors must still obtain approval for investment abroad exceeding 10,000 ringgit and there are limits on the import and export of ringgit notes. In addition, restrictions on swap transactions and on credit transactions between residents and non-residents as well as the requirement that trade be invoiced in foreign currency have been retained. Relaxation of these controls should be done in a carefully sequenced manner. The substantial programs now underway for improving the financial sector regulatory and supervisory framework should be suitably advanced especially in regard to the risks associated with cross-border transactions as capital account reforms are introduced. A consistent monetary policy and exchange regime should be in place. In this regard the authorities have indicated their intention to maintain the peg for the time being. Some change might be necessary fairly soon, however. At present the ringgit is undervalued raising the risk of an inward surge of short term capital in anticipation of an exchange rate adjustment. Currently BNM is sterilizing inflows and accumulating reserves. It would be best if the shift to a more flexible exchange regime could be made before these pressures build and complicate the process of liberalizing capital account transactions.

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[4] In particular there are no exit taxes in Indonesia, Thailand, China, Korea or the Philippines. Most countries other than Indonesia and the Philippines apply income taxes to interest, dividends, profits and capital gains However, unlike the exit taxes these taxes would be generate tax credits in the investors' home jurisdiction.

[5] The exit tax was modified in the 2000/2001 budget introduced on October 27, 2000 and will not be applied to capital gains on assets held for more than one year.

Summary

Controls were implemented late in the evolution of the crisis. The bulk of the portfolio outflows were already over. The exchange rate had depreciated sharply and was fixed at an undervalued level making further capital flight unlikely. The turnaround in the stock market the return of positive GDP growth, the building of reserves and the relaxation of interest rates were all coincident with the imposition of controls. But these changes are found in all the other crisis countries, and they did not follow the same control policies.

However, the controls provided insurance against the consequences of possible further disturbances. They created a breathing space for making necessary reforms and the authorities made good use of this time. The stabilization of the financial system through Danaharta and Danamodal was quick and complete. Throughout the control period the authorities have pushed ahead with regulatory and supervisory reform for the financial sector and capital markets – an important prerequisite for full capital account liberalization.

The controls were fully effective in achieving the immediate goal of closing offshore market. This helped create the scope for lowering domestic interest rates. This eased the buildup of NPLs in the financial system and insulated domestic firms from potential shocks of a further spike in interest rates and volatility of exchange rates.

The evidence presented here suggests that Malaysia may have incurred a cost in terms of the additional 300 basis point spread paid on floating rate debt after the controls were instituted and that this effect persisted over a period of about six months. There do not appear to have been serious attempts to circumvent the controls so that any damage to the integrity of the marketplace has been minimal. The exit strategy has so far not resulted in lasting capital flight of portfolio capital. FDI remains below pre-crisis levels but it is not possible at this stage to attribute this to the effect of controls.

No attempt has been made to measure the compliance and administrative costs of the controls. It is clear however that BNM made the strongest possible effort to disseminate information about the controls and to clarify misunderstandings. The preannouncement of the end of controls including the system of graduated exit taxes helped to give market participants a clear picture of what future changes could be expected.

The current undervaluation of the ringgit argues for an early move towards exchange rate flexibility which would help to smooth the way for capital account liberalization although this needs to be coordinated with progress on financial market supervision and regulation.

On balance it appears that the controls had a modest cost that was kept minimized by careful and comprehensive design and execution, but that the benefits of the controls have also been modest.

Table 1. The September 1, 1998 Changes

Prior to September 1, 1998	Effective September 1, 1999
Dealings in gold and foreign currency.	
• No restriction on foreign exchange contracts between authorised dealers and non-residents.	• No change, except for External Account holders.
External Accounts	

• Transfer between External Account holders freely allowed.
• No restrictions on credits and debits to an External Account.
	• Transfers between External Accounts require prior approval for any amount.
	• Transfers to resident accounts in Malaysia banks are permitted until 30 September 1998. Thereafter, such transfers require approval.
	• Sources of funding the External Account are limited to:
	  • Proceeds from sale of ringgit instruments, securities registered in Malaysia or other assets in Malaysia.
	  • Salaries, wages, commissions, interest or dividend.
	  • Sale of foreign currency.
	• Use of funds in the account is limited to:
	  • Purchase of ringgit assets in Malaysia.

General Payments	
• Generally residents were freely allowed to make payments to non-residents for any purpose, provided, for an amount of RM100,000 and above :- • a Form P is completed; and • the resident does not have any domestic borrowing (if the payment is for investments abroad in any form); or • the payment is made in foreign currency if in relation or consequential to a guarantee (for non-trade purposes).	• Generally residents are freely allowed to make payments to non-residents for any purpose up to RM10,000 in ringgit or its equivalent in foreign currency (reduction in amount), except for all payment for imports of goods and services • Residents are freely allowed to make payments to non-residents in foreign currency only, for amounts exceeding RM10,000 equivalent. However, investments abroad in any form and payments under a guarantee for non-trade purposes require approval. • Form P is completed for amounts exceeding RM10,000 equivalent.

Export of goods	
• Prescribed manner of payment for exports is in foreign currency or ringgit from an External Account.	• Prescribed manner of payment for exports is in foreign currency only.
Credit facilities to non-residents	
• Non-resident correspondent banks and non-resident stockbroking companies were permitted to obtain credit facilities in aggregate up to RM5 million from banking institutions to fund mismatch of receipts and payments through their External Accounts.	• Domestic credit facilities to non-resident correspondent banks and non-resident stockbroking companies are no longer allowed.
Investments abroad	
• Residents with no domestic borrowing were allowed to make payment to non-residents for purposes of investing abroad • Corporate residents with domestic borrowing were allowed to invest abroad up to the equivalent of RM10 million per calendar on a corporate group basis	• Residents with no domestic borrowing are allowed to make payment to non-residents for purposes of investing abroad, up to an amount of RM10,000 or its equivalent in foreign currency per transaction • All residents require prior approval to make payments to non-residents for purposes of investing abroad, for an amount exceeding RM10,000 equivalent in foreign currency
Foreign currency credit facilities and ringgit credit facilities from non-residents	
• Residents were allowed to obtain ringgit credit facilities of below RM100,000 in the aggregate from any non-resident individuals	• Residents are not allowed to obtain ringgit credit facilities from any non-resident individuals.

Securities	

• There was no restriction on the secondary trading of securities registered in Malaysia, between residents and non-residents, and between non-residents and non-residents.
• For transfer of securities registered outside Malaysia from non-resident to a resident, the resident was subject to the rules on investments abroad.
	• Ringgit securities are required to be deposited with authorised depositaries.
	• Ringgit securities held by non-residents must be transacted through an authorised depositary for good delivery. (see CLOB shares below)
	• All payments by non-residents for any security registered in Malaysia must be made in foreign currency or in ringgit from an External Account.
	• All proceeds in ringgit received by a non-resident from the sale of any resident security must be retained in an External Account (subject to the conditions on such accounts). However, should the ringgit security be held for more than one year, proceeds from the sale of such securities can be :
	    • Immediately converted to foreign currency; or
	    • Credited to the External Account.
	• All payments to residents for any security registered outside Malaysia from non-residents, must be made in foreign currency.

Import and export of currency notes, bills of exchange, assurance policies, etc.	

• A traveller (resident and non-resident) was freely allowed to import or export any amount of ringgit notes or foreign currency notes, which are on his person or in his baggage.
• Export of foreign currencies requires approval
• Authorised dealers were allowed to import any amount of ringgit notes, subject to reporting on a monthly basis to Bank Negara Malaysia
	• A resident traveler is permitted to import:
	    • Ringgit notes up to RM1,000 only; and
	    • any amount of foreign currencies.
	• A resident traveller is permitted to export:
	    • ringgit notes up to RM1,000 only; and
	    • any amount of foreign currencies up to the equivalent of RM 10,000.
	• A non-resident traveler is permitted to import:
	    • Ringgit notes up to RM1,000 only; and
	    • Any amount of foreign currencies.
	• A non-resident traveler is permitted to export:
	    • Ringgit notes up to RM1,000 only; and
	    • foreign currencies up to the amount of foreign currencies brought into Malaysia
	• Prior approval is required for the import and export of ringgit notes and the export of foreign currency notes, other than as permitted above.
	• Transitional provision: Up to 30 September 1998, permission is given to a traveler (resident and non-resident) to import any amount of ringgit on his person or in his baggage.

CLOB Shares	
• Trading in Malaysian shares in the Singapore's over-the-counter market was possible because the law requiring shares to be registered in the KLSE was not strictly enforced	• Enforcement of the registration law effectively freezes CLOB share transactions.

Labuan International Offshore Financial Centre	
• Licensed Offshore Banks were allowed to trade in ringgit investments up to permitted limits.	• Licensed Offshore Banks are no longer allowed to trade in ringgit instrument

Table 2: Changes Made after September 1, 1998

September 2, 1999 • The Ringgit is fixed at 3.8 to the dollar, which was close to the range it had been trading in for the previous few days.
February 15, 1999 • The one year waiting period on conversion of portfolio investment is replaced with a system of graduated levies depending on the holding period. For repatriated principal the levies are related to holding periods as follows: Up to 7 months 30%; 7 to 9 months 20%; 9 to 12 months 10% more than 12 months 0%. Interest dividends, rental income and proceeds of real estate transactions attract no exit levy. For repatriated profits the levy is 30% for profits repatriated within 12 months and 10 percent thereafter.
February 18, 1999 • Exit levies on the Second Board stocks (the technology heavy MESDAQ) are dropped.
March 1, 1999 • Relaxation of import and export of ringgit from RM1,000 to 10,000 for traders at certain border stations.
September 1, 1999 • The graduated levy system set up n February expires meaning that only investments made since September 1, 1998 are subject to the 10% exit tax on capital gains.
September 21, 1999 • Investments made between September 1, 1998 and February 14, 1999 are exempted from the 10% exit levy on principal.
February 14, 2000 • Agreement reached on a phased reintroduction of CLOB share trade and opening the of individual security accounts with the Malaysian Central Depository.

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